Journal of Accountancy

Volume 57 | Issue 2 Article 3

2-1934

Shortcomings of Present-Day Financial Statements

W. A. Paton

Shortcomings of Present-Day Financial Statements*

By W. A. Paton

The topic assigned to me, "Shortcomings of present-day financial statements," has perhaps been worn rather threadbare by much discussion. It is a well-recognized fact, however, that there is much confusion of mind, even among those closely in touch with business affairs, with respect to the fundamental principles and concepts underlying financial statements, and that modern statement practice, even as exemplified in the periodic reports of leading corporations, could be greatly improved. And under such conditions there is some excuse for an occasional critical survey of the field, notwithstanding the fact that this may involve the reiteration of numerous points which are commonplaces to experienced accountants.

To illustrate the prevailing confusion of mind as to fundamentals may I refer to an account appearing in the *Detroit Free Press*, issue of September 13th, this year, dealing with the question of the eligibility of banks for admission to the insurance pool, which attributed to Walter J. Cummings, chairman of the board of directors of the Federal Deposit Guarantee Corporation, a very remarkable conception of the balance-sheet. The following is an excerpt from the newspaper story:

> Requirements Eased Somewhat
>
> The directors of the Guarantee Corp. have evolved a more elastic interpretation of solvency for application in determining a bank's eligibility than was used in opening closed banks. Their first concern will be to see that no bank is admitted that will be a potential drain on the insurance pool.
>
> Liquidity will not be considered, says Walter J. Cummings, chairman of the corporation's board. The test will be whether the bank in question has sufficient resources to meet its liabilities. Instead of requiring that assets be sufficient to pay depositors and other creditors, a bank will be ruled admissible if assets and capital combined will do this.

I think you will all agree that if Mr. Cummings can increase the resources available to meet bank liabilities by combining total assets and capital he is nothing short of a wizard.

As an example of the fact that statement practice in the case of the rank and file of American enterprises is not always what it

*An address delivered at the annual meeting of the American Institute of Accountants, New Orleans, October, 1933.

should be I shall call your attention to a weird concoction issued by a small insurance company:

——— ——— ——— INSURANCE COMPANY

Condensed statement as of December 31, 1932

Income

Total assets at close of business December 31, 1931		$117,967.26
Total income for year 1932		28,994.39
		$146,961.65

Disbursements

Losses and loss adjustment expenses	$ 10,890.76	
Management and directors' fees	6,000.00	
Printing, advertising, postage, office expense and rent	5,748.19	
Car account and establishing agencies	1,231.14	
Auto purchase account	1,815.00	
Agency commissions	5,563.55	
	$ 31,248.64	

Assets

Reserve for losses	$ 10,193.83	
Reserve for unearned premiums	9,874.60	
Reserve for security value fluctuation	8,500.00	
Bills receivable (non-admitted)	15,668.93	
Surplus	71,475.65	
	$115,713.01	
		$146,961.65

It would be difficult to imagine a more jumbled layout of accounting data than the above. The use of red (italic) figures for the footings is a crowning technical touch.

What I have to offer is merely a series of observations with respect to the present weaknesses of financial statements, organized under three more or less distinct heads, as follows:

1. Form and content of balance-sheet.
2. Form and content of income sheet.
3. Possible lines of development.

Form and Content of Balance-Sheet

Asset valuation accounts. Improper presentation of contra valuation accounts is still a familiar shortcoming in balance-sheet arrangement. With respect to allowances for accrued depreciation and similar estimates, it is true, practice has been improving decidedly in recent years, due in considerable measure to the influence of leading firms of public accountants. Most large companies in the manufacturing field now exhibit depreciation reserves as modifying elements on the asset side. In the public-utility field, on the other hand, most enterprises adhere to the older practice of treating such accounts as surplus items or reserves on the liability side. This contrast in procedures, it may be added, does not indicate fewer or less effective accountants in public utilities than in manufacturing; the explanation of the attitude of the utilities lies rather in the problem of rate regulation.

Although the treatment of estimates of accrued depreciation as offsets to assets has become standard practice, almost never are these estimates presented in the balance-sheet in a fully satisfactory manner. The well-nigh invariable procedure is to show depreciation reserves as a deduction from an amalgam of depreciable and non-depreciable values, as follows:

Land, buildings, machinery and equipment at manufacturing plants, service warehouses and sales offices, at cost........	$27,455,593
Less reserve for depreciation............................	11,163,778
	$16,291,815

Admitting the need for condensation in published statements it can still be insisted that the situation is not adequately displayed unless the extent of the estimated depreciation is shown in relation to the cost or other basic value subject to depreciation; and this requires the segregation of land and other forms of property which are deemed to be non-depreciable.

Objection may also be raised to presentations in which it is impossible to distinguish depreciation from allowances for depletion, amortization or other forms of write-down. Where two or three internal columns are employed it requires only four or five lines to show separately the status of: (1) land and similar assets; (2) resources subject to depletion; (3) buildings, equipment and other depreciable assets; (4) patents or other intangibles requiring amortization.

The foregoing implies that the showing in the balance-sheet of net book values only—a practice followed by a few companies—is unsatisfactory. Perhaps one is not justified in criticizing this procedure very severely, but it does seem to me that it is not commendable, at least in so far as the fixed assets are concerned.

To deduct depreciation reserves and similar accruals from the gross values, reporting only the residual figures, gives an air of precision and finality to what are at the best nothing more than careful estimates. The practice also leaves the reader of the statement completely in the dark as to the status of the plant and the company's policy with respect to it. It is much better to give candid expression to the actual situation, thus permitting the reader, on the basis of a summary of all the available data, to formulate his own final opinion. In reporting the cost of the existing property together with the write-down which has been accrued to date the company is in effect saying to all interested:

> "Here is what we have invested in those depreciable plant assets which are still functioning and here is the amount which in all the circumstances it has seemed advisable for us to extinguish, as operating costs or as losses, up to the present time. The net balance, subject to the question of salvage, is the amount which we feel can reasonably be charged to future operations as a measure of the service of these assets to the future."

One other matter should be mentioned before leaving this subject of the exhibit of fixed asset values and the modifying reserves. Whatever our individual opinions may be as to the merit of appraisals, and the advisability of adjusting accounting records and statements in the light of data made available by appraisers, we can all agree that if appraisal data are to be recognized in the statements the disclosure should be clear and complete. And yet this is seldom done in practice. The following illustrates the typical presentation:

Property, plant and equipment (values are based on cost or on field surveys by company's engineers, supplemented where necessary by independent appraisals, with subsequent additions at cost)	$159,188,276.50
Less reserves for depreciation	60,509,943.49
Net property, plant and equipment	$ 98,678,333.01

It would be much more illuminating, of course, if the amount of cost were first shown, together with the amount of the depreciation reserve applicable to cost, and the amount of enhancement or write-down resulting from the appraisal, with the modifying depreciation adjustment, were displayed as a supplement to the cost data. A diligent search of published reports over a period of years, however, has failed to disclose a single ideal presentation.

The following is one of the few efforts I have noted which indicated a desire to present the entire story:

Property, plant and equipment, at original book values.....	$4,293,014.93
Less reserve for depreciation...........................	1,074,555.74
	$3,218,459.19
Appreciation resulting from appraisal by the ——— appraisal company..	584,468.90
Appraised sound value, plus subsequent additions at cost less depreciation................................	$3,802,928.09

Treasury securities. Another class of contra valuation accounts consists of those which modify primary liability or other equity balances. Current practice is decidedly weak with respect to the handling of such accounts in the balance-sheet. The most common account of this class is that which shows treasury securities—stocks, bonds or notes. The cost or par value of such securities is often displayed as an asset under the general title "investments" or a similar caption, and in the case of bonds and notes acquired under debt retirement programs the "sinking fund" prominently displayed as a first-class asset, in the pew adjoining cash and the other sanctified current items, is often wholly or largely composed of the obligations of the reporting company. About fifteen years ago THE JOURNAL OF ACCOUNTANCY published a paper of mine in which was presented what I still believe was a fairly convincing argument in support of the proposition that all securities in the hands of the obligor or issuing company, whatever their origin or method of acquisition, were, like corresponding securities which had been authorized but never issued, nothing more nor less than contra valuation items, and should therefore be shown as deductions from the primary accounts on the liability side instead of being listed among the assets. Apparently my story has made little impression on practice, which need not be surprising to any one. At the same time the proposition I have referred to has its supporters. The classifications and statements prescribed by the interstate commerce commission have always required the enterprises under the commission's jurisdiction to treat treasury securities as contra equity accounts. The bureau of internal revenue has consistently refused to interpret any form of treasury stock as an element of invested capital. And in a number of published statements of industrial concerns one finds treasury securities excluded from the asset side of the balance-sheet.

It would not be appropriate here to attempt to reproduce at length the arguments on either side of this treasury-stock and treasury-bond question. Let me say, however, that I am convinced that many accountants have been misled is this matter by legal technicalities which have very little significance as far as sound statements are concerned. Whether a security has been legally canceled or not, as Lyon pointed out years ago in his *Corporation Finance*, has no serious bearing on the question of its effective status in the financial statement of the issuing company. Some have also been misled by taking too seriously the proposition that if money is actually paid for stocks or bonds they must represent assets, even if they consist of the securities of the buyer, on the ground that anything for which money is voluntarily paid constitutes valid property. The difficulty can be readily resolved by bearing in mind that funds can be expended to retire capital equities, either temporarily or permanently, or to reduce effective outstanding indebtedness, as readily as to incur costs or to acquire assets. The man who retires his note at the bank, for example, can presumably take advantage of his "line" of credit and reissue such note, in effect, at a later time if he so desires, and undoubtedly he "pays" for the note when he takes it up, but it would never occur to him that either feature of the case would justify the treatment of the note, while in his possession, as an asset. No more should the corporation, which, acting in the dual capacity permitted in some jurisdictions, "buys" its own outstanding securities, recognize the cost thereof as a valid asset in its balance-sheet.

Security discounts. A third class of valuation items often poorly handled in the balance-sheet consists of security discounts. Discount here should be defined as the difference between the par, face or maturity value of the security issued and the amount of cash or its equivalent actually contributed to or turned over to the corporation by the first bona-fide owner of the security. As you all know the usual treatment of discounts consists either in burying them in property over-valuation or in setting them up as an asset in combination with miscellaneous items under "deferred charges" or some similar head.

In the case of stock discount it has been long contended by Hatfield and other careful students of accounting procedure that there is no justification for the view that this factor constitutes an asset and that such discount should accordingly be exhibited in the balance-sheet as an offset to the stated par value of the outstanding stock. It is true that the excess of par value over the amount contributed by the original stockholders is—to the extent that it is legally assessable—a type of contingent asset, but again it should be insisted that a sharp distinction must be drawn between the mere possibility of raising funds under very special and rather remote conditions (and after the taking of very definite legal steps) and recognizable assets. In general, contracts and relationships which are wholly unperformed by all parties concerned do not give rise to definite assets and liabilities, notwithstanding their importance from the legal standpoint.

Many corporations in the past have avoided the appearance of stock discount by making their stock nominally fully paid and non-assessable by issuing it originally against property at an inflated valuation; and in general no serious legal difficulties have been thrown in the way of this procedure. Where this is done the "water" is covered by apparent assets in the balance-sheet and to the extent that such values are subject to depreciation or amortization the expenses of ensuing years are correspondingly padded. In those cases in which a legal discount is involved, the practice has been to include the amount of the discount as a special item on the asset side, that item being later written off against earned surplus as surplus became available. To treat stock discount as a current expense or as a deferred charge to operations is obviously improper. One large company in 1919 charged an item of stock discount amounting to over $160,000 to general expense and had the naïveté to set this charge up as an allowable deduction in its federal tax return. The commissioner of internal revenue naturally objected. It should be noted, however, that this is the same type of blunder as that which is involved when stock discount is set up as a deferred charge to operations and is written into expenses over a period of years. Further, if stock discount—an amount of nominal capital which has not been raised—is carelessly confused with underwriting costs and other organization costs—expenditures for services actually performed—and it is the policy of the concern to write off its organization costs in a period of two to five years, the result is a definite and inexcusable padding of operating expenses. This error is not uncommon and flows directly from careless analysis and slipshod balance-sheet presentation.

It is to be doubted if the recommendations of academicians as to the treatment of stock discount will ever make much headway as far as actual practice is concerned, especially in view of the rapid development of no-par stocks, so-called, and the consequent waning importance of the phenomenon of discount. It does not follow, however, that these recommendations are unsound.

With respect to discounts on bonds and similar securities the universal practice is to treat the amount of the discount, usually amalgamated with the underwriting and other issuing costs, as a deferred charge to operations. This treatment is erroneous, as a bond discount—the difference between maturity value and the amount of money paid into the corporate treasury by the bondholders—is no more an asset than is stock discount. To rule otherwise is equivalent to saying that the amount of property received by a corporation incident to the issue of bonds is always equal to the par or maturity value, regardless of the amount of the discount; and this is tantamount to denying the fact of discount. That is, if bond discount is a true asset, then a corporation issuing bonds always receives 100 cents (the cash or other property plus the amount of the discount) for each dollar of par value issued—a manifestly absurd proposition. The proper initial treatment for such discount is to set it up as a contra on the liability side, thus:

First mortgage, 6%, bonds, due in 1943:	
Amount due at maturity	$1,000,000
Discount due at maturity	50,000
Net amount paid in by bondholders	$ 950,000

This treatment has of course long been recognized as the correct one by all actuaries, including one who was also an outstanding accountant, Colonel Sprague. It is a rather sad commentary on the logic of accountants in general that they all persist in presenting bond discount on the balance-sheet as an asset.

I will cheerfully admit that no serious harm flows from the traditional accounting treatment of bond discount. We all agree that the item must be systematically accumulated through the life of the bonds as an adjustment of the interest charges; and it is quite evident that the equity of the stockholder—that all-important element—is in no way affected in our statements whether we treat unaccumulated bond discount as an asset or as a contra to bonds-par. Further, distinguishing bond discount from the underwriting cost is not a matter of grave moment as the underwriting cost must also be extinguished during the life of the security (although it is not entirely satisfactory to include amortized underwriting charges, amalgamated with an element of discount, in periodic interest charges). It happens to be one of those cases where the correct treatment has only minor advantages over the wrong treatment. On the other hand we did have a case in Michigan a few years ago where the state authorities, accepting a taxpayer's balance-sheet—which included a large item of bond discount as an asset—as a correct picture, levied a tax which would have been substantially less had the theory that bond discount is a contra account rather than an asset been adopted.

There is one thing I wish we might agree to, and that is to discard the misnomer "prepaid interest," substituting the actuarial expression, "unaccumulated discount." For over twenty years I have been searching diligently for a genuine case of prepaid interest and thus far have met with no success. Far from being "prepaid interest," bond discount is of course "unpaid interest," and what is more it is not paid until the very end of the contract. On the theory that it is unwise in any field to continue to employ preposterously inaccurate terminology we would do well to abandon entirely our ancient friend "prepaid interest."

Incidentally, I notice in a model balance-sheet for a lumber company, appearing in the September, 1933, issue of THE JOURNAL OF ACCOUNTANCY, the use of both prepaid interest (under "prepaid expenses") and bond discount (under "deferred charges") as captions on the asset side. It is difficult to see how both of these captions can be used to advantage, quite aside from any question of the interpretation of discount.

Deferred charges. This brings us to a consideration of a very objectionable feature of most balance-sheets: namely, the use of the heading "deferred charges" (also sometimes labeled "prepaid expenses" or "unadjusted debits") as a catch-all for a miscellany of items, some of which have a rather dubious character. Granting the need for summarization in statement presentation, it can still be urged that care should be taken to avoid grouping widely divergent elements under a single head, especially if this means that balances about which there is any question are thereby obscured. In this world of complex and shifting economic factors accountants can perhaps be excused for failing to demonstrate the absolute validity of this or that financial element of the business enterprise; we are not living up to our possibilities, however, when we fail to make use of clear and discriminating descriptions. The solution of many accounting problems, in other words, is simply complete disclosure.

The classification of deferred charges in accounting reports is used to cover a multitude of sins. Among the different types of balances which have been found included in certified statements under this head are the following:

1. Inventories of supplies of various kinds.
2. Advances or prepayments on account of insurance policies, leases, royalty contracts, etc., and on account of ordinary payrolls.
3. Organization costs, underwriting costs, and other costs of raising capital and launching the business.
4. Costs of experimentation and development.
5. Losses and deficits.
6. Doubtful claims and receivables and other dubious balances held in suspense.
7. Discounts on stocks and other securities.

If it is objectionable to aggregate such items under "deferred charges" or some other noncommittal label, how should they be handled? The answer is that each case should be considered on its merits and disposed of accordingly. Inventories of supplies can very reasonably be dealt with, through the use of a somewhat more complete title, as are other inventories. It is true that supplies are not viewed as salable merchandise, but in general they are as legitimate a current asset as are most classes of raw materials and work in process. (I am assuming, of course, that a subtotal of cash, marketable securities and first-class current receivables will be displayed under the broad division of current assets.) Likewise all current prepayments and advances, redeemable in the due course of operations in the form of services or goods, should be grouped as a special type of current asset. Organization costs and all related charges should be shown separately on the balance-sheet, clearly and fully described, and placed last on the asset side (unless goodwill and other intangibles are involved —in that case the intangibles may well be listed last). If these charges represent bona-fide payments, on a cash or equivalent basis, for legal services, underwriting services, etc. which have been engaged on a competitive market and actually received, they deserve a place in the balance-sheet and need not be viewed as a dubious asset. After all, why is an unquestioned payment for the essential service of securing the necessary capital any less an asset than any other legitimate expenditure required in launching and equipping the enterprise? Such charges, however, attach to the enterprise as a whole and are not assignable to any specific tangible object. It should also be admitted, perhaps, that organization and promotion costs are somewhat more subject to padding and misrepresentation than are the costs of acquiring or constructing plant assets. For these reasons the recommendation is made that costs of this type be displayed separately and be described fully. In fact, it would often be advisable to support the balance-sheet item by a special schedule showing its composition in some detail under such heads as incorporation fees, cost of legal counsel, accounting, stationery and supplies, underwriting charges, etc., and in any event the break-up in the ledger should be along the lines indicated.

Costs of experimentation and development, the fourth item listed above, have a questionable status in the balance-sheet, because of the unusual degree of uncertainty as to the outcome attaching to such changes and the practical difficulties in the way of developing a reasonable plan of capitalization and subsequent amortization. The use of the term "deferred charge" as a special caption in this case is not altogether unreasonable, and if the application of the term could be restricted to this class of charges there would be some justification for its retention.

Losses and deficits and highly doubtful suspense items should, of course, not be recognized as asset values in any circumstances. Such balances should either be written off against income or surplus, or—if no income or surplus is available—should be deducted from the capital account or, in the case of par value stocks, be set up as a contra on the liability side. Discounts on stocks and other securities as explained above, have no legitimate place on the asset side but should be treated as contra items in relation to the main security accounts.

Upon examination, then, of the several classes of balances found in the balance-sheet catch-all, it appears that with one possible exception the group can be broken down, and effectively disposed of, without undue elaboration of the statement.

Capital and surplus. The proper presentation of the stock equities is a matter of the first importance and most published statements are sadly lacking at this point. Whose interest in statements is more acute or more justified than that of the stockholder? And what fact is of more significance to the stockholder than a clear-cut picture of the amount of his equity as the accountant sees the situation? In comparatively few balance-sheets, however, are the accounts so arranged as to display clearly the book value of the stock interest, and in many cases the data are presented in such a muddled fashion that even the trained accountant finds it rather difficult to make the computation to his satisfaction.

Among the objectionable practices are:

1. Listing of capital stock and surplus accounts at opposite extremes of liability side.
2. Combination of surplus and non-surplus reserves.
3. Failure to distinguish adequately between surplus reserves, asset valuation reserves and liabilities labeled as reserves.

It would seem to be entirely reasonable to insist that capital accounts, unappropriated surplus and true surplus reserves be juxtaposed and that a total of the stock equity be taken and prominently displayed on the face of the balance-sheet, supplemented, perhaps, by a calculation showing book value per share.

Another objectionable feature of many statements is the obscurity resulting from the juggling of capital surplus on the one hand and earned surplus on the other, with donated surplus and surplus from appreciation sometimes thrown into the picture for good measure. Either we should abandon the terms "capital" and "surplus" in corporate statements, and be satisfied with a conglomerate net-worth item, determined by subtracting the total of liabilities from the recognized total of assets, or we should exert every effort in the direction of attaching a definite and trustworthy meaning to these expressions. Capital, according to the common-sense conception, is the amount actually contributed by the stockholders to the enterprise; surplus, by the same test, measures the amount of earnings retained in the business. What a blessing it would be if statement practice conformed to these simple and widely appreciated definitions! In the actual situation, however, the capital and surplus figures appearing in the statement often have no effective meaning when taken individually. As a result in particular of the manipulation of accounts accompanying reorganization and recapitalization, the practice of crediting a part of the original contribution directly to surplus, and the transfer of additional slices of capital to surplus accounts in revaluations, and the reverse practice of capitalizing surplus through stock dividend issues and otherwise, the respective amounts of capital and surplus have lost all significance in many cases.

It should be added that the responsibility for this condition by no means rests solely on the shoulders of accountants. The fault lies primarily in a structure of corporation acts framed by lawyers not adequately grounded in accounting and finance. If the whole matter lay within the power of the organized accountants, I believe that simplification and rationalization of the capital and surplus muddle would be not long in coming. I might say that I should like to see the American Institute of Accountants draft and sponsor a model corporation code, based upon sound financial administration and good accounting practice, as I believe such a move might have a decidedly beneficial effect on future legislation.

This brief discussion of the presentation of capital and surplus has ignored many complications, including those introduced by the use of preference issues. Where two or more kinds of stock are outstanding, an ideal exhibit of capital and surplus, no doubt, should show an assignment of value to each issue. To accomplish this in a defensible fashion, however, is often very difficult especially where special rights and conditions which involve surplus attach to the preference issue or issues. In some of these cases, as Professor Hatfield once put it, "what man hath joined together not even God himself can rend asunder."

Summary of balance-sheet criteria. The following is a tabular statement of the principal points to be observed in balance-sheet construction:

As to general form

1. Title should include name of company, general caption and effective date.
2. Presentation of assets and liabilities on left and right facing pages is the most common and satisfactory form provided adequate provision is made for internal calculations, subordinate captions and subtotals.
3. Adequate descriptions, with references to any supporting schedules, should appear in the body of the statement.
4. Full comments and qualifying explanations should appear in body of statement or in footnotes.

As to asset side

1. Order should run from most highly current or realizable items to most fixed and unrealizable.
2. Under current assets a subtotal of cash, marketable securities and first-class current receivables should be displayed, and a total of all current assets should be taken.
3. Reserves for bad debts and other offsets should be shown as deductions from gross values, net balances being extended.

4. Basis of valuation of inventories should be clearly indicated.
5. Sinking funds should appear as an independent item, between the current and fixed groups. Such funds should not include the securities of the reporting company.
6. Investments in affiliated companies and other long-term or non-marketable securities owned should be shown as a separate item following the current assets. The company's own issues should not be included.
7. Under the subhead of "plant assets" non-depreciable items should be segregated and depreciation reserves should be shown as applying only to the depreciable assets. The same point should be observed in the case of depletion. Adjustments due to revaluation should be segregated, together with any depreciation provision applicable thereto.
8. Organization and underwriting costs should be shown separately.
9. Intangibles should be shown separately, as a final item on asset side.

As to liability side

1. Current liabilities should come first, a subtotal being shown. A high degree of condensation is justified here. So-called reserves for tax liabilities and other definite liabilities should be included in this division.
2. The fixed liabilities should follow the current items. Great detail is not required for most purposes. Bonds and notes in treasury or in special funds should be treated as contra items. The same is true, ideally, of discounts.
3. A total of all liabilities, both current and fixed, should be shown. (Few statements meet this requirement.)
4. Reserve liabilities of an indeterminate character, such as reserves for workmen's compensation, pension reserves, maintenance guaranties and the like, should follow the typical liabilities as an intermediate group.
5. The stock equity should be prominently displayed under the sub-head, "capital and surplus."
6. Treasury stock and true discounts should appear as contras.
7. Subtotals should be shown for capital (including stock premium or capital surplus) and true surplus. Under surplus the subheads of unappropriated and appropriated (reserved) surplus should appear.
8. Surplus from appreciation should be segregated and a total of the stock equity shown before inclusion of this element.
9. Where one or more issues of preference stock are outstanding a total of the common stock equity should be shown, if the legal rights are such as to make this feasible, as well as a final total of all stock equities.

Model condensed balance-sheet. The following is an outline condensed balance-sheet which emphasizes in its form and arrangement some of the points listed above:

M COMPANY

Balance-sheet of assets, liabilities and stock equity

As of December 31, 19—

Assets

Current:	
Cash on hand and in banks..........................	xxx
Marketable securities (basis of valuation indicated).....	xxx

Notes and accounts receivable	xxx			
Less: allowances for uncollectibles and other adjustments	xx	xxx	xxx	
Inventories of materials, supplies, work in process and finished stock (basis of valuation indicated)			xxx	
Prepayments—unexpired insurance, salary advances, etc.			xx	xxx
Investments in affiliated companies (basis of valuation)				xxx
Plant:				
Land—cost		xxx		
Land—appreciation		xxx	xxx	
Buildings and equipment—cost		xxx		
Less: allowance for accrued depreciation		xxx	xxx	xxx
Organization costs (reference to supporting schedule)				xx
Patents, processes and trademarks				xx
				xxxx

Liabilities and Stock Equity

Current liabilities:				
Accounts and notes payable		xxx		
Payrolls, taxes, interest, and other accruals		xx		
Dividends payable		xx		
Advances by customers		x	xxx	
Long-term liabilities:				
First mortgage, 6% bonds—				
Amount due at maturity		xxx		
Less: unaccumulated discount		xx	xxx	
Total liabilities				xxx
Capital and surplus:				
Capital stock—preferred (details)			xxx	
Equity of common stock				
Capital stock—common (details)—				
Par or nominal values	xxx			
Premiums or capital surplus	xxx	xxx		
Earned surplus—				
Appropriated (reference to schedule)	xxx			
Unappropriated	xxx	xxx		
		xxx		
Less: cost of treasury stock, unassigned		xx		
		xxx		
Surplus from land appreciation		xxx	xxx	
Total net worth				xxx
				xxx

Form and Content of Income Sheet

The use of the systematic income report has been greatly extended in recent years, and there has been considerable development with respect to the technical form of statement employed. In general the account form, with its array of more or less baffling and undigested debits and credits, has been abandoned, and an elastic analytical type of report has been substituted. At the same time there is plenty of room for improvement in the typical corporate income sheet, particularly with respect to arrangement and emphasis.

Gross profit. In my judgment one of the shortcomings of the traditional income report, as universally outlined in textbooks and widely used in practice, is the emphasis upon the so-called "gross profit" balance. In the trading field this figure measures the excess of gross revenues or sales over the cost of merchandise, including transportation charges and other assigned costs. In manufacturing the term is applied to the excess of the total flow of revenue (usually measured in sales) over the cost of materials, direct labor and all other costs which have been assigned to manufacturing operations by the cost accountant. It follows that in manufacturing, in particular, the nature of the gross profit margin varies with the character of the cost system.

My objection to the emphasis on this element is based, in the first place, on the belief that the figure has so little significance as to be almost worthless and that, accordingly, it should be given no prominence in the general income report. Of what value is a balance derived by deducting from revenues a particular type of cost or expense? At any rate, of what peculiar value is such a balance as compared with numerous other figures which might be obtained by a similar process? In merchandising, for example, is the difference between sales and the cost of merchandise as such any more significant than the difference between sales and selling costs? I see no reason other than tradition for giving a particular type of cost a preferential position and treating the excess of revenues over such cost as an element of peculiar financial importance.

In the second place, the stress on gross profit tends to irrational thinking, on the part of the owners of the business as well as outsiders, which may lead to unfortunate results. "Gross profit" is, of course, not profit in any proper sense. The use of the term, however, and its prominent display in statements often colors the proprietor's attitude and tends to prevent him from focusing his attention sharply upon the all-important relation between total cost of operation and revenues. There is, in fact, some evidence that where the business man is thoroughly steeped in the "gross-profit" concept he is more inclined to look favorably on unsound pricing policies. In the case of the outsider, with little knowledge of accounts, the emphasis on gross profit may lead to the conviction that the business is making unwarranted profits. Without much doubt the impression which many consumers have to the effect that profiteering is rampant in numerous retail lines is fostered by comparisons of the cost of the merchandise or materials involved with the selling price of the finished article. And in the hands of the agitator, gross profit data constitute a part of the ammunition employed in his campaign of misrepresentation.

The accountant believes, supposedly, that all necessary costs of operation are on precisely the same level so far as economic validity and influence upon prices are concerned; and he should accordingly not be guilty of presentations of data which convey quite a different impression. It would be my recommendation that no balance of any kind be struck in the income report until all expenses of operation (not including, however, interest and other charges which constitute a distribution of net earnings) have been aggregated. The first significant balance to be displayed in other words, is net operating revenue. This recommendation, it should be understood, need in no way discourage the presentation of a classification of expenses in as much detail as is desired or expedient. The objection raised is not to the elaboration of cost data but to the striking of intermediate operating balances having little or no significance and unfortunately labeled.

I am willing to grant that in departmental statistics and reports there may be some justification for the calculation of gross margins. That is, if it is not feasible to allocate all costs involved to the respective departments, and it is therefore not possible to determine and compare final net revenues by departments, it may be worth while to compute and study the intermediate balances derived by deducting all assignable costs from departmental sales. Even such calculations are less important than is commonly assumed, and marked caution must be exercised in reaching conclusions on the basis of departmental gross-profit data.

Nothing that I have said denies the importance of calculating and using operating ratios. But the determination of all the operating ratios desired is in no way dependent upon the showing of gross profit in the income statement, or anywhere else for that matter. The ratio of the total cost of operation to total revenues, or the ratio of any particular cost or group of charges to revenues, can be readily ascertained and presented without any reference to so-called gross profit.

I am glad to be able to add that a considerable number of large corporations have in recent years abandoned the practice of striking gross-profit balances in their income reports.

Depreciation. The exclusion of depreciation charges from the operating expense group is still an exceedingly common practice, and apparently a considerable number of public accountants are quite willing to fall in line with the wishes of corporate managements on this matter. I am one of those, however, who are convinced that this practice is decidedly unsound and should not be countenanced by reputable accountants.

Is depreciation an unquestioned cost of operation, on the same fundamental level as current charges for materials and labor? Or is it an optional charge, a quasi-imaginary element which we can recognize or not as we please, or as business politics would seem to dictate? In his well-known work on accounting Professor Hatfield answers this question very clearly and convincingly. As he points out, the view that depreciation of plant assets is not a genuine operating cost, on a footing with other charges, has no real foundation. To refer to his example, the cost of the coal burned by the locomotive is no more a cost of transportation than the cost of the locomotive itself; and one is no more surely consumed in operation than is the other. One can also go a step further and insist that the notion—apparently held by many supposedly sophisticated accountants—that depreciation is not an out-of-pocket cost, like labor and materials, but is a "mere bookkeeping entry," is utterly ridiculous. Depreciation is an out-of-pocket cost; it represents actual expenditure, and the expenditure represented is not in the future, as so many seem to think, but in the past. The difference between labor cost, for example, and depreciation, or building and equipment cost is not that the former is an out-of-pocket cost and the latter a mere provision for the future. The difference lies in the fact that in the case of buildings and equipment the expenditure is required in advance, whereas in the case of labor the outlay is made currently. But in both cases the expenditure is unquestioned and is actually incurred prior to the recognition of the charge to operation. (I am here following the conventional usage of including liabilities incurred under the general term "expenditure.")

Why can't we all get together and agree that we are done with tolerating the manipulation of the depreciation account by corporate managements interested in painting a special kind of picture for the readers of their statements? Granting that the amount of the periodic charge is an estimate and that no one can demonstrate precisely what this amount should be, can we not nevertheless refuse to coöperate in the complete omission of depreciation from the income report, and can we not insist that the minimum charge, whatever the amount may be, must be deducted before there is any use of the term "net profit?"

Again it is gratifying to note that many of our outstanding corporate managements have not permitted themselves to be beguiled, through these years of depression, by the various popular schemes of radically reducing or of "ducking" entirely their program of depreciation charges; and increasing numbers are displaying their depreciation charges, without quibbling, as operating expenses.

Purchase discounts. Most concerns treat sales discounts, together with returns and similar adjustments, as an offset to nominal sales figures. On the other hand, many companies adhere to the practice of displaying purchase discounts in the income report as a special financial earning, not associated with operation in the narrow sense. As an expression of my views on this point, which correspond to those held by many other accountants, I quote a brief statement from the *Accountants' Handbook.*

"The distinction between savings and earnings is a matter which is continually coming up in accounting procedure. The outstanding example is the question of the treatment of purchase discounts. Are such discounts an actual earning, as many still insist, or are they merely an offset to nominal cost figures which have been booked in gross in conformity with tradition and convenience? Those who hold that such discounts are an earning argue that the discounts taken through prompt payment of bills are an earning of the working capital of the enterprise, a financial income akin to interest. Those on the other side insist that such discounts represent merely a convention in pricing and billing practice, and as such are cost adjustments.

"It seems clear that the proper interpretation of such discounts, in a great majority of cases, is that they are credits to nominal costs. If the offering of such discounts were an unusual and special occurrence, and advantage could be taken of them only by concerns with unusually favorable financial position, there would be some justification for the other view. But, as a matter of fact, the offering of cash discounts is a commonplace of business practice, a conventional habit of more or less doubtful origin, and the taking of such discounts has likewise become a commonplace, to be taken for granted in the case of any well-managed concern. In other words, the real price is regularly the net cash price, and the matter is so understood by both parties. Indeed, if it were not for the somewhat unfortunate practice of listing and billing in terms of gross price, the amount of the discount being indicated more or less parenthetically as a percentage, it would never occur to any bookkeeper to do otherwise than book the net price. There is much to be said for a change in practice in bill writing. If prices were listed and invoices written in terms of net cash prices, with the amount of a penalty for unduly delayed payment clearly indicated, it would be a great convenience in bookkeeping and might tend to make the regular acceptance of discounts by the buyer still more of a commonplace rule than it is at present. Or, as a compromise, the practice of the public-utility companies in showing gross, amount of discount, and net amount—with the last figure emphasized—might well be more widely adopted."

Treatment of losses. How to display special losses, as opposed to operating charges, has always been a moot questoin. The distinction between a loss (an expenditure or collapse of value which is not accompanied by a contribution to the financial welfare of the enterprise) and an expense (an expired cost factor which has contributed to the flow of revenues) is in principle entirely clear. In practice, however, it is by no means always easy to draw the line. In general, accountants favor the inclusion in operating charges of all minor items the precise nature of which is more or less debatable, and at the same time recognize the propriety of charging conspicuous losses, obviously quite outside the scope of the normal activities of the business, to surplus accounts. With this recognition of a distinction between revenue and surplus charges has come the development of the surplus analysis or surplus statement as a separate schedule or report.

Of late many accountants have been recognizing that some dangers are involved in these tendencies, especially in these days where losses are the rule and managements are trying desperately to bolster up appearances. It is objectionable, of course, to endeavor to make a more favorable operating showing than circumstances warrant by an unduly liberal use of the surplus account, especially where the surplus analysis is omitted from the regular report or is not prominently displayed. The solution appears to lie not in giving up the distinction between expenses and losses in reports but in a broad conception of the income sheet as a complete statement of revenue, expenses, income allocations and surplus. In other words, there is something to be said for discouraging the development of the surplus analysis as a separate statement, and for the use of a combined income and surplus report which tells the whole story, concluding with the final surplus balance as it appears on the balance-sheet, in one connected series of data. To be effective in preventing improper presentation the surplus account under this procedure must be conceived as including all surplus reserves which involve entries affecting profit and loss in any measure.

Location of dividend charges. A score of years ago I heard a statement by Henry Carter Adams which impressed me. This statement was to the effect that one of the four or five most important balances which it is the duty of the accountant to disclose is the final addition to or deduction from surplus. If this statement is to be taken seriously the very common practice in the income sheet of displaying dividends as a charge against surplus rather than against current net is objectionable. I know that surplus constitutes a sort of dividend reservoir (from the legal point of view, at least) and that the appropriation of dividends from surplus is recognized on all sides as perfectly good practice. I also know that corporate managements dislike showing a red figure in the income report, emphasizing the failure to earn dividend requirements currently. However, if we admit that the purpose of the income report is to show the actual situation in the most clear and discriminating fashion possible, must we not agree that to "soft-pedal" the amount which must be drawn from past earnings to meet current dividends is not the best practice?

Model outline form for condensed income sheet. The following is drawn from the section entitled "Income Determination" in the *Accountants' Handbook:*

M Company
Statement of income and surplus
for period Ended December 31, 19—

Gross sales or volume of business (classified or departmentalized as fully as desired)		$ . . . . .
Sales adjustments (discounts, returns, etc., and, possibly, regular allowance for uncollectibles)		. .
Net Sales		$ . . . . .
Operating expenses (classified and supported as fully as desired)		. . . .
Net operating revenue (from principal activity)		$ . . . .
Ancillary gross revenue	$ . .	
Ancillary expenses	. .	
Ancillary net revenue		. .

Total operating net revenue		$ . . . .
Special net income (interest, dividends, etc.)		. .
		$ . . . .
Special net deductions (non-operating losses assignable to current period)		. .
Total net income		$ . . . .
Interest charges (classified and detailed as desired)		. . .
Net income before taxes		$ . . .
Income-tax appropriation		.
Net to stockholders		$ . . .
Preferred dividends		. .
NET TO COMMON STOCK		$ . . .
Common dividends		. .
Addition to surplus (or, in case of red figure, deduction from surplus)		$ . .
Surplus at beginning of period	$	
Losses (not applicable to current period)	. .	. . . .
Surplus per balance-sheet		$ . . . .

Possible Lines of Statement Development

Two-section balance-sheet. The capital-account and current-account balance-sheet, a device rarely found in American accounting, has merits which have seemed to escape general attention. One of the serious difficulties in balance-sheet presentation is the problem of finding effective means of contrasting the two very different groups of assets involved, the highly liquid and readily realizable items on the one hand, and the dedicated cost factors, realizable without heavy loss only through a long period of successful operation, on the other. Balance-sheet practice might be made more rational, and the inherent limitations of the balance-sheet might be more widely understood, if the statement were prepared in two distinct sections, one of which was restricted —from the standpoint of assets—to the realizable resources. Were this done the point of view prevailing in the preparation of the current account statement, and in its interpretation, would justly be that of present effective value in the face of possible immediate liquidation. The capital-account statement, in contrast, would be prepared without qualification from the going-concern standpoint and would largely ignore the question of liquidation values. In a separate capital-account statement, for example, there would need be no hesitancy in showing organization costs and all other valid commitments as asset balances. The basic difficulty in balance-sheet construction and interpretation at present are the conflicting views and cross-purposes involved, and this difficulty might be largely obviated through a development in the direction indicated.

Use of statistical methods. In preparing financial statements accountants should make more use of the familiar devices of the statistician, especially index numbers; and I confidently predict decided developments in this direction before many years have passed. Although caught up in a legal system that tends to restrict the application of the statistical approach the accountant can nevertheless go far beyond his present efforts.

I have in mind in particular the possibility of reducing to a common denominator accounting data originating on different price levels. When one stops to think about the matter he finds himself astonished that accountants have been so sluggish in dealing with this problem. Aside from the efforts of Mr. Sweeney and one or two others there has been almost no systematic attention given to this serious question in accounting circles. The statistician, in presenting export and import figures, for example, or any other series of financial data involving a number of years, proceeds as a matter of course to make his figures more justly comparable through the use of index numbers. The accountant, in setting up comparative balance-sheets, and in other matters, has been content to present unadjusted data.

As I intimated above, the accountant faces a peculiarly difficult task in using index numbers because of the extent to which his material involves contractual relationships, legal conceptions of income and other complications. But that something can be done to supplement our present forms of reports has been amply demonstrated. And in view of what has been happening of late to our monetary unit, and what may happen in the future, it behooves us to "get busy."

Depicting interrelations of funds. After blowing hot and cold several times on the merits of the statement of funds as a supplementary type of financial statement, I have finally come to the conclusion that this device has real possibilities and that its use should be extended. Undoubtedly the ebb and flow of funds, implicitly and explicitly, is not fully depicted by the conventional income report and accompanying balance-sheet, and enough has already been done with flow-of-funds statements to demonstrate their effectiveness in portraying essential relationships and movements.

With respect to form, the funds statement is in need of further experimentation. In particular an effort should be made to get away from the conception of this report as two balancing sides, analogous to the balance-sheet. A running form similar to the income statement, and focused on some residual element such as the change in net working capital, is to be preferred.

This type of statement also has possibilities in working out implicit relationships not directly reflected in ordinary transactions. For example, there might be incorporated in a statement of this kind an analysis of the composition of surplus from the standpoint of asset values.

Cumulative reports. Among the developments in statement practice which may be looked for in the future is the greater use of cumulative reports. The typical business enterprise under modern conditions is a living institution, a continuous organization. It is no longer a case of embarking on a voyage to the East Indies, of returning with the spoils, and of dividing up and living happily forever after. And it follows that an occasional snapshot of a rather artificially conceived financial condition, accompanied by glimpses of severed segments of activity, are rather inadequate tools with which to limn the financial fabric of the business in a vital fashion. As Justice Brandeis has pointed out, the ordinary balance-sheet and income-sheet data are only tentative and conjectural statements and can not be verified finally and fully until the enterprise has run its entire course. It is to be expected, therefore, that in their endeavor to improve the effectiveness of their work accountants will give more and more attention to presentations of data covering longer periods and having cumulative aspects.

For example, extension of the use of cumulative reports covering the entire history of the company to date as seen from a cash standpoint can be expected. Such statements are now occasionally employed by accountants (see example on page 132) and they undoubtedly have a value in portraying the effects of the entire range of the transactions of the enterprise. A complete historical income report might be prepared similarly and be brought down to date and issued once a year. Or it might be found even more helpful to issue cumulative reports covering the period of the last three to five years. Still another variation, well worthy of serious consideration in relation to the income sheet, is the cumulative average report.

The cumulative report is not being suggested as a substitute for the comparative statement (which undoubtedly should be continued and further developed) but as another form of report which would supplement the ordinary balance-sheet and income statement in a useful way.

Quincy Mining Company
General summary of receipts and expenditures from organization to December 31, 1930

Receipts

From capital stock paid in	$ 200,000.00	
" " " (scrip)	1,250,000.00	
" " " 10,000 shares increase	700,000.00	
" 40,000 shares treasury stock	500,000.00	
" capital stock 50,000 shares increase	1,250,000.00	
" " " 25,421 " "	635,525.00	
		$ 4,535,525.00
" proceeds of copper and silver (765,477,355 pounds copper)		122,352,433.99
" interest		785,168.52
" profit on sale P. L. & R. Impr. Co. stock, etc.		103,775.16
" sales of real estate, Hancock, Michigan		310,072.74
" instalment payments not completed		13,088.00
		$128,100,063.41

Expenditures

For expenditure on location previous to 1856	42,097.98	
" expenditure on Quincy vein 1858, not now worked	55,000.00	
" openings on 3,800 feet Pewabic vein, extending to portage lake, preparatory to future work	11,500.00	
" real estate and permanent improvements	10,508,479.50	
" mining, smelting and marketing copper, and all incidental costs	90,183,074.60	
		$100,800,152.11
Balance		$ 27,299,911.30
Deduct dividends declared Nos. 1 to 127		27,002,500.00
Balance as per statement on a preceding page		$ 297,411.30